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1984 Dodge/Sweet's Construction Outlook

Second Update
July 1984

Goodbye Housing... Hello Commercial

After two years of recovery, the dynamics of the building cycle are shifting from residential to nonresidential building. Ordinarily this would mean that the best is yet to come as the combination of sustained high-level housing activity and still-expanding commercial and industrial contracting brings the cycle to its peak during the third year. However, the premature rise of interest rates early in 1984 is threatening to bring this cycle to an early end as housing appears headed for a second-half decline. In the light of this development, the short term construction outlook is reduced to two questions:

- How steep will be the decline of housing starts in the months ahead?
- Is there enough potential in the commercial and industrial building sectors to cover the expected decline of homebuilding?

The Interest Rate Issue

There are several reasons why interest rates should be coming *down*, but they aren't convincing when matched against the Federal deficit as the reason why they are rising instead. Until the deficit's dominance of the credit market is relieved (and that won't happen in 1984), the present "loose fiscal/tight monetary" environment will have to be endured.

As the Federal Reserve restricts the growth of the supply of credit, the combined demands of the Treasury (which is pre-empting more than half of the economy's savings in order to finance its deficits) and the business sector (which is only now warming up to a strong wave of capital spending) are pushing rates higher. Under the circumstances, it is only a matter of time before housing starts begin to wither.

This uncomfortable situation isn't going to change much until the underlying problem—the deficit that everybody loves to hate—is addressed in a meaningful way. Proposals for deficit reduction that are now under consideration by Congress should eventually allow the Fed to relax its grip on the credit market by substituting fiscal restraint for monetary restraint. But whatever compromise solution is reached over the summer won't become effective until 1985 at the earliest, leaving interest rates hanging high for several quarters.

How high will interest rates go before turning down again? Are we on another trip to the realm of the 20 percent prime and the 18 percent mortgage?

Economic priorities are not the same in 1984 as they were in 1980. Sustaining growth now takes precedence over driving inflation out of the system (at least until it can be shown that inflation is galloping again). Concern about third world debtors adds a new dimension to credit policy. In line with these priorities, the interest rate assumptions underlying this forecast of construction activity are:

- Rates are close to the limit of their current upswing, but will continue to drift a bit higher through the second half of 1984 and into early 1985.
- There is the opportunity for a reversal of interest rates by the middle of 1985 when economic activity will have slowed considerably, and when fiscal policy will begin to address the deficit issue.

Housing

Through mid-1984, at least, the one-point-plus hike in mortgage rates had not yet turned the housing cycle down. Outstanding commitments at more favorable terms were still supporting a strong 1.9 million unit rate of starts in the month of May, although the forces of decline were already in motion.

One-family housing starts averaged 1.05 million units (annual rate) through 1984's first half with only a modest (5 percent) fall-off in the second quarter. If mortgage rates, which have recently advanced from 13 percent to 14 percent,

do not reach 15 percent by the end of the year, recent experience at these lofty levels indicates that a fourth-quarter rate of 925,000 one-family housing starts remains possible.

As the year's stronger first-half volume is eroded by rising interest rates during the third and fourth quarters, 1984's one-family housing potential must be adjusted back to 1.0 million units—approximately even with 1983's total, but moving in the opposite direction.

Multi-family housing is headed for an extraordinary 800,000 unit volume in 1984—the largest total since the early 1970's. Instead of leveling off at about 650,000 units, a rate that would have been consistent with the 1.1 million unit peak reached by one-family housing last winter, multi-family building soared to 800,000 units where it still remains. The obvious implication: something besides the respite in interest rates has been stimulating multi-family building during the past several quarters.

Life styles of the 1980's, as much as the high cost of conventional one-family houses, are responsible for the popularity of condominiums as the starter home for many young families. But in addition, accelerated depreciation has triggered a minor boom in apartment construction.

Rising mortgage rates are bound to lead to a weakening of the condo market during 1984's second half, but tax-sheltered apartments are likely to remain an active market for a while longer as the probability grows that terms will be less favorable to investors in 1985.

Total housing starts in 1984's second half are expected to average 1,740,000. This compares with the 1,860,000 rate reached during the first half when the housing cycle was rounding its peak, and should bring the year's total to an even 1.80 million units.

Maximum stress of rising interest rates is most likely to bear on the housing market during the middle quarters of 1985, when the rate of starts is tentatively forecast to sink as low as 1,550,000 units. An improved final quarter is expected to bring next year's total to 1,575,000 units.

1984 National Estimates
Dodge Construction Potentials

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		1983 Actual	1984 Forecast	Percent Change 1984/83
Nonresidential Buildings				
Floor Area (millions of square feet)	Office Buildings	281	275	– 2
	Stores & Other Commercial	362	480	+33
	Manufacturing Buildings	107	140	+31
	Total Commercial & Manufacturing	750	895	+19
	Educational	73	76	+ 4
	Hospital & Health	84	76	–10
	Other Nonresidential Buildings	116	118	+ 2
	Total Institutional & Other	273	270	– 1
	Total Nonresidential Buildings	1,023	1,165	+14
Contract Value (millions of dollars)	Office Buildings	$ 19,766	$ 20,100	+ 2
	Stores & Other Commercial	13,798	18,375	+33
	Manufacturing Buildings	5,080	6,900	+36
	Total Commercial & Manufacturing	$ 38,644	$ 45,375	+17
	Educational	$ 6,157	$ 6,900	+12
	Hospital & Health	8,560	8,325	– 3
	Other Nonresidential Buildings	8,544	8,975	+ 5
	Total Institutional & Other	$ 23,261	$ 24,200	+ 4
	Total Nonresidential Buildings	$ 61,905	$ 69,575	+12
Residential Buildings				
Dwelling Units* (thousands of units)	One-Family Houses	1,000	1,000	—
	Multi-Family Housing	719	800	+11
	Total Housekeeping Residential	1,719	1,800	+ 5
Floor Area (millions of square feet)	One-Family Houses	1,578	1,578	—
	Multi-Family Housing	682	769	+13
	Nonhousekeeping Residential	78	97	+24
	Total Residential Buildings	2,338	2,444	+ 5
Contract Value (millions of dollars)	One-Family Houses	$ 61,765	$ 65,525	+ 6
	Multi-Family Housing	25,919	30,400	+17
	Nonhousekeeping Residential	5,517	7,100	+29
	Total Residential Buildings	$ 93,201	$103,025	+11
Nonbuilding Construction				
Contract Value (millions of dollars)	Highways & Bridges	$ 15,219	$ 17,825	+17
	Sewer & Water	7,536	7,425	– 1
	Other Public Works	7,210	8,050	+12
	Total Public Works	$ 29,965	$ 33,300	+11
	Utilities	$ 7,680	$ 5,000	–35
	Total Nonbuilding Construction	$ 37,645	$ 38,300	+ 2
All Construction				
Contract Value (millions of dollars)	Total Construction	$192,751	$210,900	+ 9
	Dodge Index (1977 = 100)	138	151	

*F.W. Dodge basis

Nonresidential Building

The nonresidential building cycle, in typical fashion, is a year behind the housing market, leaving much of its potential still to be realized. For forecasting purposes, the several building types that make up this group can be put into two classes: safe, and risky. Most prominent among the "safe" categories (i.e., high assurance of continued gains): stores, warehouses, manufacturing buildings.

The retail building market (stores and warehouses) is on its way to two years (1984 and 1985) of high-volume building as it responds to needs created by the recent surge of residential building. This year's strong 1.8 million unit volume of housing starts is capable of supporting as much as 425 million square feet of retail building, but owing to the normal lag in this building market, the impact of 1984's homebuilding on contracting for stores and warehouses will be diffused throughout 1984 and 1985. Total volume of slightly more than 400 million square feet is anticipated for both years (vs. 300 million in 1983) as contracting in the retail building market achieves its peak early in 1985.

By the time the economy's expansion reaches its limit (in 1987), manufacturers will be operating at about 86 percent of capacity—a rate not often exceeded. And by that time, contracting for *industrial*

1984 Regional Estimates
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Northeast	CT, ME, MA, NH, NJ, NY, PA, RI, VT	1983 Actual	1984 Forecast	Percent Change 1984-83
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$ 5,972	$ 7,300	+22
	Institutional and Other	4,160	4,350	+ 5
	Total	$10,132	$11,650	+15
	Residential Buildings			
	One-Family Houses	$ 6,871	$ 7,675	+12
	Multi-Family Housing	3,607	4,175	+16
	Nonhousekeeping Residential	986	1,125	+14
	Total	$11,464	$12,975	+13
	Nonbuilding Construction			
	Highways and Bridges	$ 2,387	$ 3,075	+29
	Other Public Works	2,830	2,925	+ 3
	Utilities	313	400	+28
	Total	$ 5,530	$ 6,400	+16
	Total Construction	$27,126	$31,025	+14

South	AL, AR, DE, DC, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV	1983 Actual	1984 Forecast	Percent Change 1984-83
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$15,575	$17,875	+15
	Institutional and Other	8,941	9,450	+ 6
	Total	$24,516	$27,325	+11
	Residential Buildings			
	One-Family Houses	$29,148	$29,775	+ 2
	Multi-Family Housing	12,686	14,200	+12
	Nonhousekeeping Residential	2,386	3,175	+33
	Total	$44,220	$47,150	+ 7
	Nonbuilding Construction			
	Highways and Bridges	$ 5,786	$ 6,350	+10
	Other Public Works	5,259	5,500	+ 5
	Utilities	2,151	2,000	– 7
	Total	$13,208	$13,850	+ 5
	Total Construction	$81,944	$88,325	+ 8

North Central	IL, IN, IA, KS, MI, MN, MO, NE, ND, OH, SD, WI	1983 Actual	1984 Forecast	Percent Change 1984-83
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$ 7,314	$ 8,825	+21
	Institutional and Other	4,513	4,700	+ 4
	Total	$11,827	$13,525	+14
	Residential Buildings			
	One-Family Houses	$ 9,867	$10,475	+ 6
	Multi-Family Housing	3,211	3,950	+23
	Nonhousekeeping Residential	683	975	+43
	Total	$13,761	$15,400	+12
	Nonbuilding Construction			
	Highways and Bridges	$ 4,204	$ 5,125	+22
	Other Public Works	3,011	3,125	+ 4
	Utilities	1,376	900	–35
	Total	$ 8,591	$ 9,150	+ 7
	Total Construction	$34,179	$38,075	+11

West	AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY	1983 Actual	1984 Forecast	Percent Change 1984-83
Contract Value (millions of dollars)	**Nonresidential Buildings**			
	Commercial and Manufacturing	$ 9,783	$11,375	+16
	Institutional and Other	5,647	5,700	+ 1
	Total	$15,430	$17,075	+11
	Residential Buildings			
	One-Family Houses	$15,879	$17,600	+11
	Multi-Family Housing	6,415	8,075	+26
	Nonhousekeeping Residential	1,462	1,825	+25
	Total	$23,756	$27,500	+16
	Nonbuilding Construction			
	Highways and Bridges	$ 2,830	$ 3,275	+16
	Other Public Works	3,646	3,925	+ 8
	Utilities	3,840	1,700	–56
	Total	$10,316	$ 8,900	–14
	Total Construction	$49,502	$53,475	+ 8

buildings, at 215 million square feet, will be approximately double last year's poor showing of only 107 million square feet. Between those extremes lie several years of prospective gains.

In 1984's first quarter, when capacity utilization had already advanced to 81 percent, the rate of industrial building—120 million square feet—was clearly not keeping up with the rapid pace of economic activity. Quarter-by-quarter gains in contracting are expected to bring the fourth quarter rate to 160 million square feet, putting the year's total at an estimated 140 million. Another sizable gain in 1985 is indicated.

A few other nonresidential building types which are mainly derivatives of homebuilding—e.g., religious, social and recreational facilities—can also be included in the group of "safe" short-run gains. Examples of "risky" building markets where special situations are more important than general trends include offices, hospitals and health care facilities.

"Precarious" is as good a word as any to describe the current state of the office building market. The extraordinary office building boom of the past five years, which produced as much new office space as was built in the previous ten years, began with the firm support of strong demographics. After satisfying the

space needs of a rapidly growing white collar labor force, the boom was ready to call it quits in 1982. Instead, it was kept alive by a change in depreciation rules which turned into a speculative bubble sustained by tax shelters.

As Congress bends to the task of preparing a fiscal package of taxation and spending cuts designed to reduce the deficit, tax shelters are high on the hit list. The anticipation by real estate investors of the inevitable loss of some (not all) of the advantages of a 15-year write-off probably had a lot to do with the resurgence of office building in 1984's second quarter when contracting soared above 300 million square feet.

So it becomes necessary to raise the 1984 forecast of office building to bring it into line with (un)reality. The possibility that some projects that had been planned for 1985 are being accelerated in order to qualify for present depreciation schedules is reason to expect a total of as much as 275 million square feet in 1984—virtually even with last year's strong volume. In 1985, a sharper drop (to about 200 million square feet) may now be indicated.

The hospital/health care building market is faced with another new source of uncertainty—the control of runaway Medicare/Medicaid expenses by adherence to standardized costs (Diagnostic Related Groups). As hospital administrators become increasingly cost-conscious in their attempt to deliver medical care at DRG prices, targeted areas of economy are (1) payrolls, and (2) length of patient stay. In both cases, success in controlling these costs ultimately translates into a reduced need for space.

Our current estimate of contracting in 1984 reflecting experience to date is a decline of nearly 10 percent.

With more "safe" than "risky" elements to the nonresidential building outlook, 1984's contracting is now adjusted upward to 1,165 million square feet for an advance of 14 percent over the 1983 total.

Public Works Construction

Partly due to a technicality, 1984 contracting for public works construction is headed for a double-digit gain over last year's total.

The Surface Transportation Assistance Act, which was the biggest event in the public works arena in a long time, began dispensing approximately $5 billion extra annual funding for highways, bridges, and mass transit in 1983's *second* quarter, and is still going strong. This means, simply, that in 1984 this new program will be operational for a full year after last year's late start. The result: an "automatic" increase in highway/bridge construction this year of 15 percent or more.

Other public works construction contracting (for water resources, sewer and waste treatment facilities, etc.) was running a bit ahead of forecast in 1984's first half, presumably because many state and local governments found themselves with unexpectedly large budget surpluses.

Total public works construction for all of 1984 is now estimated to reach $33.3 billion, a gain of 11 percent over 1983's value.

This last look at 1984 reveals a construction market that will be considerably different by the end of the year than it was at the beginning. Before midyear, rising interest rates were bringing the housing cycle to a premature end. During the remainder of the year, nonresidential building will be increasingly dominant.

To a large extent, this is the normal sequence of cyclical development, but events since the start of the year are accelerating the process.

Nevertheless, there remains enough momentum in the nonresidential markets to carry 1984's contracting for total new construction forward another 9 percent to a record $210.9 billion.

The construction sector will be put to a more severe test in 1985 when the big issue will be: Will the deficit problem be addressed seriously enough to relieve the pressure on interest rates so housing can recover?

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The Outlook

Nonresidential Building Contract Value

Seasonally adjusted annual rates, in billions of dollars

Year/Quarter		Total	Commercial/ Industrial	Institutional
1983	I	$59.5	$37.2	$22.3
	II	60.1	36.4	23.7
	III	63.1	40.2	22.9
	IV	64.8	40.6	24.2
1984	I	$67.3	$43.6	$23.7
	II	72.8	49.0	23.8
	III	69.6	45.3	24.3
	IV	68.6	43.7	24.9
1983		$61.9	$38.6	$23.3
1984		$69.6	$45.4	$24.2
% Change		+12	+17	+ 4

Residential Building Contract Value

Seasonally adjusted annual rates, in billions of dollars

Year/Quarter		Total	One-Family	Multi-Family*
1983	I	$ 84.5	$57.1	$27.4
	II	92.7	63.9	28.8
	III	99.1	63.7	35.4
	IV	96.4	62.3	34.1
1984	I	$104.9	$70.0	$34.9
	II	106.3	67.7	38.6
	III	101.9	63.6	38.3
	IV	99.0	60.8	38.2
1983		$ 93.2	$61.8	$31.4
1984		$103.0	$65.5	$37.5
% Change		+11	+ 6	+19

*Includes Nonhousekeeping Residential Buildings

Nonbuilding Construction Contract Value

Seasonally adjusted annual rates, in billions of dollars

Year/Quarter		Total	Public Works	Utilities
1983	I	$31.8	$25.8	$ 6.0
	II	48.8	32.1	16.7
	III	38.8	32.3	6.5
	IV	31.2	29.6	1.6
1984	I	$35.8	$33.0	$ 2.8
	II	36.4	32.2	4.2
	III	40.0	34.0	6.0
	IV	41.0	34.0	7.0
1983		$37.7	$30.0	$ 7.7
1984		$38.3	$33.3	$ 5.0
% Change		+ 2	+11	−35